

## § 1.423-1

## 26 CFR Ch. I (4-1-01 Edition)

incentive stock option plan must be approved:

(a) By a majority of the votes cast at a duly held stockholders' meeting at which a quorum representing a majority of all outstanding voting stock is, either in person or by proxy, present and voting on the plan; or

(b) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

[T.D. 8374, 56 FR 61160, Dec. 2, 1991]

### § 1.423-1 Applicability of section 421(a).

(a) *General rule.* Subject to the provisions of section 423(c) and paragraph (k) of this section, the special rules of income tax treatment provided in section 421(a) apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an option granted after December 31, 1963, under an employee stock purchase plan provided that the following conditions are satisfied—

(1) The individual must make no disposition of such share within 2 years from the date of the granting of the option, nor within 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) after the transfer of such share to him; and

(2) At all times during the period beginning with the date of the granting of the option and ending on the day three months before the date of such exercise, the individual must be an employee of either the corporation granting the option, a related corporation of such corporation, or a corporation or a related corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applies.

(b) *Cross-references.* For rules relating to the employment relationship, see paragraph (h) of § 1.421-7. For rules relating to the effect of a disqualifying disposition, see section 421(b) and paragraph (b) of § 1.421-8. For definition of

the term “disposition”, see section 425(c) and paragraph (c) of § 1.425-1.

[T.D. 6887, 31 FR 8798, June 24, 1966, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

### § 1.423-2 Employee stock purchase plan defined.

(a) *In general.* (1) The term “employee stock purchase plan” means a plan which meets the requirements of paragraphs (1) through (9) of section 423(b). If the terms of the plan do not satisfy the requirements of paragraphs (3) through (9) of section 423(b), such requirements may be satisfied by the terms of an offering made under such plan. However, in such a case, such requirements will be treated as satisfied only with respect to options exercised under such offering.

(2) The determination of whether a particular option is an option granted under an employee stock purchase plan is made at the time such option is granted. If the terms of an option are inconsistent with the terms of the employee stock purchase plan or an offering under such a plan, the option will not be treated as granted under an employee stock purchase plan. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4). If such an option is granted to an individual who is not entitled to the grant of an option under the terms of the plan or offering, such option will not be treated as an option granted under an employee stock purchase plan, and the grant of the option will not disqualify the plan or the options granted under such plan or offering. For example, an option granted to an individual who is ineligible to receive an option under an employee stock purchase plan by reason of his ownership of 5 percent or more of the voting power or value of the stock of the grantor corporation

(or a related corporation of such corporation), will not be treated as an option granted under an employee stock purchase plan, and the grant of such an option will not disqualify options granted under such plan from the special tax treatment of section 421. If all the options granted under an offering do not give the respective optionees the same rights and privileges, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. If, at the time an option is granted, it qualifies as an option granted under an employee stock purchase plan, but the terms of the option are not in fact met, the option will not qualify for the special tax treatment of section 421. However, the failure of such an option to qualify for the special tax treatment of section 421, will not disqualify other options granted under the plan.

(b) *Options restricted to employees.* An employee stock purchase plan must provide that options are to be granted only to employees of the employer corporation or of its related corporations to purchase stock in any such corporation. If such a provision is not included in the terms of the plan, the plan will not be an employee stock purchase plan and options granted under such plan will not qualify for the special tax treatment of section 421. For rules relating to the employment requirement, see paragraph (h) of § 1.421-7.

(c) *Stockholder approval.* (1) An employee stock purchase plan must be approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. The approval of the stockholders must comply with all applicable provisions of the corporate charter, bylaws and applicable State law prescribing the method and degree of stockholder approval required for the issuance of corporate stock or options. If the applicable State law does not prescribe a method and degree of stockholder approval in such cases an employee stock purchase plan must be approved—

(i) By a majority of the votes cast at a duly held stockholder's meeting at which a quorum representing a majority of all outstanding voting stock is,

either in person or by proxy, present and voting on the plan; or

(ii) By a method and in a degree that would be treated as adequate under applicable State law in the case of an action requiring stockholder approval (i.e., an action on which stockholders would be entitled to vote if the action were taken at a duly held stockholders' meeting).

(2) The plan required by section 423 must be approved within 12 months before or after the date the plan is adopted. Ordinarily, a plan is adopted when approved by the board of directors and the date of such board action will be the reference point for determining whether stockholder approval comes within the 12-month period.

(3) The plan as adopted and approved must designate the aggregate number of shares which may be issued under the plan, and the corporations or class of corporations whose employees will be offered options under such plan. A plan which merely provides that the number of shares which may be issued under options shall not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan will not satisfy the requirement that the plan state the aggregate number of shares which may be issued under options. However, the maximum number of shares which may be issued under the plan may be stated in terms of a percentage of either the authorized, issued or outstanding shares at the date of the adoption of the plan. The provisions relating to the aggregate number of shares to be issued under the plan and the employees (or class of employees) eligible to receive options under the plan, are the only provisions of a stock option plan which require stockholder approval for purposes of section 423(b)(1).

(4) Any increase in the aggregate number of shares which may be issued under the plan (other than an increase merely reflecting a change in capitalization such as a stock dividend or stock split-up) will be treated as the adoption of a new plan requiring approval of the stockholders within 12 months of such adoption. Similarly, a change in the designation of corporations whose employees may be offered options under the plan will be treated

as the adoption of a new plan requiring stockholder approval unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the grantor corporation and its parent or subsidiary corporations. The group from among which such changes and designations are permitted without additional stockholder approval may include corporations having become parents or subsidiaries of the grantor after the adoption and approval of the plan. Any other changes in the terms of an employee stock purchase plan may be made without such changes being considered the adoption of a new plan.

(5) A plan which otherwise meets the requirements of section 423(b) and this section may be used as an employee stock purchase plan although the adoption and approval of such plan occurred before January 1, 1964.

(d) *Options granted to certain shareholders.* (1) An employee stock purchase plan must by its terms provide that no employee can be granted an option if such employee, immediately after the option is granted, owns stock possessing 5 percent or more of the total combined voting power or value of all classes of stock of the employer corporation or its parent or subsidiary corporation. In determining whether the stock ownership of an employee equals or exceeds this 5 percent limit, the rules of section 425(d) (relating to attribution of stock ownership) shall apply, and stock which the employee may purchase under outstanding options (whether or not such options qualify for the special tax treatment afforded by section 421(a)) shall be treated as stock owned by the employee. An option is outstanding for purposes of section 423(b)(3) although under its terms it may be exercised only in installments or after the expiration of a fixed period of time. If an option is granted to an individual whose stock ownership (as determined under this paragraph for purposes of section 423(b)(3)) exceeds the limitation of section 423(b)(3), no portion of such option will be treated as having been granted under an employee stock purchase plan.

(2) The determination of the percentage of the total combined voting power or value of all classes of stock of his employer corporation (or a related corporation of such corporation) that is owned by the individual is made by comparing the voting power or value of the shares owned (or treated as owned) by the individual to the aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option to such individual. The aggregate voting power or value of all shares actually issued and outstanding immediately after the grant of the option does not include the voting power or value of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* E, an employee of M Corporation, owns 6,000 shares of the common stock of M Corporation, the only class of M stock outstanding. M has 100,000 shares of its common stock outstanding. Since E owns 6 percent of the combined voting power or value of all classes of M Corporation stock, M cannot grant an option to E under M's employee stock purchase plan. If E's father and brother each owned 3,000 shares of M stock and E owned no M stock in his own name, the result in this case would be the same, since under section 425(d) a person is treated as owning stock held by his father and his brother. Similarly, the result would be the same if, instead of actually owning 6,000 shares, E merely held an option on 6,000 shares of M stock, irrespective of whether the transfer of stock under such option could qualify for the special tax treatment of section 421, since section 423(b)(3) provides that stock which the employee may purchase under outstanding options shall be treated as stock owned by such employee.

*Example (2).* Assume the same facts as in example (1) and assume further that M is a subsidiary corporation of P Corporation. Irrespective of whether E owns any P stock, E cannot receive an option from P under P's employee stock purchase plan since he owns 5 percent of the total combined voting power of all classes of stock of a subsidiary of P Corporation, i.e., M Corporation. Thus, an individual who owns (or is treated as owning) stock in excess of the limitation of section 423(b)(3), in any corporation in a group of corporations, consisting of a parent and its subsidiary corporations, cannot receive an

option under an employee stock purchase plan from any corporation in the group.

*Example (3).* F is an employee of R Corporation. R has only one class of stock, of which 100,000 shares are issued and outstanding. Assuming F owns no stock in R or in any parent or subsidiary of R for purposes of section 423(b)(3), R can grant an option to F under its employee stock purchase plan for 4,999 shares, since immediately after the grant of the option, F would not own 5 percent or more of the combined voting power or value of all classes of R stock actually issued and outstanding at such time. The 4,999 shares which F would be treated as owning under section 423(b)(3) would not be added to the 100,000 shares actually issued and outstanding immediately after the grant for purposes of determining whether F's stock ownership exceeds the limitation of section 423(b)(3).

*Example (4).* Assume the same facts as in example (3) and assume further that on June 1, 1965, R grants F an option, purportedly under its employee stock purchase plan, for 5,000 shares. No portion of this option will be treated as granted under an employee stock purchase plan.

(e) *Employees covered by plan.* (1) Subject to the limitations of section 423(b)(3), (5) and (8), an employee stock purchase plan must, by its terms, provide that options are to be granted to all employees of any corporation which grants options to any of its employees by reason of their employment by such corporation except that one or more of the following categories of employees may be excluded from the coverage of the plan:

(i) Employees who have been employed less than 2 years;

(ii) Employees whose customary employment is 20 hours or less per week;

(iii) Employees whose customary employment is for not more than 5 months in any calendar year;

(iv) Officers;

(v) Persons whose principal duties consist of supervising the work of other employees; and

(vi) Highly compensated employees.

No option granted under a plan or offering which excludes from participation any employees, other than those who may be excluded under section 423(b)(4) and this paragraph, and those barred from participation by reason of section 423(b)(3), (5), and (8) and paragraphs (d), (f) and (i) of this section, can be regarded as having been granted under an employee stock purchase

plan. If an option is not granted to any employee who is entitled to the grant of an option under the terms of the plan or offering, none of the options granted under such offering will be treated as having been granted under an employee stock purchase plan. Furthermore, no option will be considered as having been granted under an employee stock purchase plan if the option was granted in connection with an offering made after September 28, 1979 with respect to which employees, otherwise eligible, are denied participation to any extent because of their continuing participation or eligibility for participation in a prior plan or offering (including a prior plan or offering of a related corporation). However, a plan which, by its terms, permits all eligible employees to elect to participate in an offering will not violate the requirements of this paragraph solely because eligible employees who elect not to participate in the offering are not granted options pursuant to such offering.

(2) For purposes of section 423(b)(3) the existence of the employment relationship between an individual and the corporation participating under the plan will be determined under paragraph (h) of § 1.421-7 (relating to employment relationship).

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* M Corporation has a stock purchase plan which meets all the requirements of section 423(b) except that by its terms, options are not required to be granted to employees whose weekly rate of pay is less than \$100. As a matter of corporate practice, M grants options under its plan to all employees, irrespective of their weekly rate of pay. M's plan is not an employee stock purchase plan.

*Example (2).* Assume the same facts as in example (1) and assume further that the first offering under M's plan provides by its terms that options will be granted to all employees of M Corporation. With respect to options exercised under such offering the terms of such offering will be treated as part of the terms of M's plan. Accordingly, stock transferred pursuant to options exercised under such offering will be treated as stock transferred pursuant to the exercise of options granted under an employee stock purchase plan for purposes of section 421.

(f) *Equal rights and privileges.* (1) An employee stock purchase plan must, by its terms, provide that all employees granted options under such plan shall have the same rights and privileges; however, a plan will not fail to satisfy this requirement merely because the amount of stock which may be purchased by any employee under such plan is determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation of employees, or because the plan provides that no employee may purchase more than a maximum amount of stock fixed under the plan. Thus, the provisions applying to one option under an offering (such as the provisions relating to the method of payment for the stock and the determination of the purchase price per share) must apply to all other options under such offering in the same manner. If all the options granted under a plan or offering do not, by their terms, give the respective optionees the same rights and privileges, none of such options shall be treated as having been granted under an employee stock purchase plan for purposes of section 421.

(2) The requirements of section 423(b)(5) and this paragraph do not prevent the maximum amount of stock which an employee may purchase from being determined on the basis of a uniform relationship to the total compensation, or the basic or regular rate of compensation, of all employees. For example, if an employee stock purchase plan provides that the maximum amount of stock which each employee may purchase under the offering is one share for each \$100 of annual gross pay, options granted under such offering will be treated as meeting the requirement of section 423(b)(5). However, such a provision must not exclude employees from participation under the plan or offering. For example, a plan which provides for the grant of options based on one share for each \$100 of annual gross pay in excess of \$10,000 will not meet the requirements of section 423(b)(5).

(3)(i) Except as provided in paragraph (f)(3)(ii) of this section, a plan permitting one or more employees to apply sums which were withheld under an earlier plan or offering towards the

purchase of additional stock under the current plan or offering will be a violation of equal rights and privileges unless all employees in the current plan or offering are permitted to make payments in an amount not less than that which any employee is allowed to carry over, to be applied to the purchase of shares under the current plan or offering.

(ii) A plan will not fail to satisfy the requirements of this section merely because one or more employees are permitted to apply sums, in an amount representing a fractional share, which were withheld under an earlier plan or offering toward the purchase of additional stock under the current plan or offering.

(4)(i) Section 423(b)(5) does not prohibit the delaying of the grant of an option to any employee who is barred from being granted an option solely by reason of such employee's failing to meet a minimum service requirement until such employee meets such requirement.

(ii) The provision of this paragraph (4) may be illustrated by the following example:

*Example.* N Corporation has an employee stock purchase plan which provides that options to purchase stock in an amount equal to ten percent of an employee's annual salary at a price equal to 85 percent of the fair market value at the time the option is granted will be granted to all employees other than those who have been employed less than 18 months. In addition, the plan provides that employees who have not yet met the minimum service requirements on the date the options are initially granted will be granted similar options on the date such employment has been attained. Such plan meets the requirements of section 423(b)(5).

(g) *Option price.* (1) An employee stock purchase plan must, by its terms, provide that the option price will not be less than the lesser of—

(i) An amount equal to 85 percent of the fair market value of the stock at the time such option is granted, or

(ii) An amount which under the terms of the option may not be less than 85 percent of the fair market value of the stock at the time such option is exercised.

For definition of the term "option price", and general rules relating to

such term, see paragraph (e) of § 1.421-7. For rules relating to the determination of when an option is granted, see paragraph (c) of § 1.421-7. Any option which does not meet the minimum pricing requirements of section 423(b)(6) and this paragraph will not be treated as granted under an employee stock purchase plan irrespective of whether the plan itself or the offering satisfies such requirements. If such an option is granted to an employee who is entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 423(b)(4).

(2) The option price may be stated either as a percentage or as a dollar amount. If the option price is stated as a dollar amount, the requirement of section 423(b)(6) and this paragraph can only be met by a plan or offering in which the price is fixed at not less than 85 percent of the fair market value of the stock at the time the option is granted. If the fixed price is less than 85 percent of the fair market value of the stock at grant, the option cannot meet the requirement of section 423(b)(6) even if a decline in the fair market value of the stock results in such fixed price being not less than 85 percent of the fair market value of the stock at the time the option is exercised, since such a result was not certain to occur under the terms of the option.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* M Corporation has an employee stock purchase plan which provides that the option price will be 85 percent of the fair market value of the stock at grant, or 85 percent of the stock at exercise, whichever amount is the lesser. Upon the exercise of an option issued under M's plan, M agrees to accept an amount which is less than the minimum amount allowable under the terms of such plan. Notwithstanding that the option was issued under an employee stock purchase plan, the transfer of stock pursuant to the exercise of such option does not satisfy

the requirement of section 423(b)(6) and cannot qualify for the special tax treatment of section 421.

*Example (2).* Assume the same facts as in example (1) and assume further that at the time of grant, the fair market value of M Corporation stock is \$100 per share and that the option price is set at 85 percent of the fair market value of M stock at exercise, but not less than \$80 per share. The option satisfies the requirement of section 423(b)(6), and can qualify for the special tax treatment of section 421.

*Example (3).* Assume the same facts as in example (2), except assume that the option price is set at 85 percent of the fair market value of M stock at exercise, but not more than \$80 per share. This option cannot satisfy the requirement of section 423(b)(6) irrespective of whether, at the time the option is exercised, 85 percent of the fair market value of M stock is \$80 or less.

(h) *Option period.* An employee stock purchase plan must, by its terms, provide that options granted under such plan cannot be exercised after the expiration of 27 months from the date of grant unless, under the terms of such plan, the option price is to be not less than 85 percent of the fair market value of the stock at the time of the exercise of the option. If the option price is to be not less than 85 percent of the fair market value of the stock at the time the option is exercised, then the option period provided under the plan must not exceed 5 years from the date of grant. If the requirement of section 423(b)(7) is not met by the terms of the plan or offering, options issued under such plan or offering will not be treated as options granted under an employee stock purchase plan irrespective of whether such options, by their terms, are exercisable beyond the period allowable under section 423(b)(7) and this paragraph. An option which provides that the option price is to be not less than 85 percent of the fair market value of the stock at exercise may have an option period of 5 years irrespective of whether the fair market value of the stock at exercise is more or less than the fair market value of such stock at grant. However, if the option provides that the option price is to be 85 percent of the fair market value of the stock at exercise, but not more than some other fixed amount, then irrespective of the price paid on exercise,

the option period must not be more than 27 months.

(i) *Restriction on amount of optioned stock.* (1) Under section 423(b)(8), an employee stock purchase plan must, by its terms, provide that no employee may be permitted to purchase stock under all the employee stock purchase plans of his employer corporation and its related corporations at a rate which exceeds \$25,000 in fair market value of such stock (determined at the time the option is granted) for each calendar year in which any such option granted to such individual is outstanding at any time. In applying the limitation of section 423(b)(8)—

(i) The right to purchase stock under an option is deemed to accrue when the option (or any portion thereof) first becomes exercisable during the calendar year;

(ii) The right to purchase stock under an option accrues at the rate provided in the option, but in no case may such rate exceed \$25,000 of fair market value of such stock (determined at the time such option is granted) for any one calendar year; and

(iii) A right to purchase stock which has accrued under one option granted pursuant to the plan may not be carried over to any other option.

If an option is granted under an employee stock purchase plan which satisfies the requirement of section 423(b)(8), but such option gives the optionee the right to buy stock in excess of the maximum rate allowable under such section and this paragraph, no portion of such option will be treated as having been granted under an employee stock purchase plan. Furthermore, if the option was granted to an employee entitled to the grant of an option under the terms of the plan or offering, and such employee is not granted an option under such offering which qualifies as an option granted under an employee stock purchase plan, such offering will not meet the requirements of section 423(b)(4). Accordingly, none of the options granted under such offering will be eligible for the special tax treatment of section 421.

(2) The limitation of section 423(b)(8) and this paragraph applies only to options granted under employee stock

purchase plans and does not limit the amount of stock which an employee may purchase under qualified stock options (as defined in section 422(b)), restricted stock options (as defined in section 424(b)), or any other stock options (except those to which section 423 applies). Stock purchased under options to which section 423 does not apply will not limit the amount which an employee may purchase under an employee stock purchase plan, except for purposes of the 5-percent stock ownership provision of section 423(b)(3).

(3) Under the limitation of section 423(b)(8), an individual may purchase up to \$25,000 of stock (based on the fair market value of such stock at the time the option was granted) in each calendar year during which an option granted to such individual under an employee stock purchase plan is outstanding. Alternatively, an individual may purchase more than \$25,000 of stock (based on the fair market value of such stock at the time the option was granted) in a calendar year, so long as the total amount of stock which he purchases does not exceed \$25,000 in fair market value of such stock (determined at the time the option was granted) for each calendar year in which the option was outstanding. If in any calendar year the individual holds two or more outstanding options granted under employee stock purchase plans of his employer corporation, or a related corporation of such corporation, his purchases of stock attributable to such year under all such options must not exceed \$25,000 in fair market value of such stock (determined at the time such options were granted). Under an employee stock purchase plan, an individual may not purchase stock in anticipation that the option will be outstanding for some future year. Thus, the individual may purchase only the amount of stock which does not exceed the limitation of section 423(b)(8) for the year of the purchase and for preceding years during which the option was outstanding. Thus, the amount of stock which may be purchased under an option depends on the number of years in which the option is actually outstanding. The amount of stock

which may be purchased under an employee stock purchase plan may not be increased by reason of the failure to grant an option in an earlier year under such plan, or by reason of the failure to exercise an earlier option. For example, if an option is granted to an individual and expires without having been exercised at all, the failure to exercise the option does not increase the amount of stock which such individual may be permitted to purchase under an option granted in a year following the year of such expiration. If an option granted under an employee stock purchase plan is outstanding in more than one calendar year, stock purchased pursuant to the exercise of such an option will be applied first, to the extent allowable under section 423(b)(8) and this paragraph, against the \$25,000 limitation for the earliest year in which such option was outstanding, then, against the \$25,000 limitation for each succeeding year, in order. For example, if an individual purchases \$60,000 in fair market value of stock (determined at the time the option was granted) by the exercise of an option granted under an employee stock purchase plan of his employer corporation, and if such option was outstanding in 3 calendar years, then \$25,000 in fair market value of such stock (determined at the time the option was granted) will be attributed to the first calendar year in which such option was outstanding, another \$25,000 in fair market value of such stock will be attributed to the second calendar year in which such option was outstanding, and the remaining \$10,000 in fair market value of such stock will be attributed to the last calendar year in which such option was outstanding. Thus, the individual may receive a right under another option granted under such employee stock purchase plan (or under an employee stock purchase plan of a parent or subsidiary corporation of his employer corporation) entitling him to purchase another \$15,000 in fair market value of such stock (determined as of the date such option is granted) for such last calendar year.

(4) The application of section 423(b)(8) and this paragraph may be illustrated by the following examples:

*Example (1).* Assume that P Corporation maintains an employee stock purchase plan and that E is employed by P. On June 1, 1964, P grants E an option under the plan to purchase a total of 750 shares of P stock at \$85 per share. On such date, the fair market value of P stock is \$100 per share. The option provides that it cannot be exercised after May 31, 1966. Under section 423(b)(8), the option must not permit E to purchase more than 250 shares of P stock during the calendar year 1964, since 250 shares are equal to \$25,000 in fair market value of P stock determined at the time of grant. During the calendar year 1965, E may purchase under such option an amount of P stock equal to the difference between \$50,000 in fair market value of P stock (determined at the time the option was granted) and the fair market value of P stock (determined at the time of grant of the option) purchased during 1964. During the calendar year 1966, E may purchase an amount of P stock equal to the difference between \$75,000 in fair market value of such stock (determined at the time of grant of the option) and the total amount of the fair market value of such stock (determined at the time of grant of the option) purchased under such option during the calendar years 1964 and 1965. E may purchase \$25,000 of stock for the year 1964 and \$25,000 of stock for the year 1966, although the option was outstanding for only a part of each of such years. However, E may not be granted another option under an employee stock purchase plan of P or a related corporation to purchase stock of any of such corporations during the calendar years 1964, 1965, and 1966, so long as the option granted June 1, 1964, is outstanding. If this option permitted E to purchase only \$15,000 of P's stock for each year it is outstanding, then E could be granted another option by P, or by a related corporation, in 1964, permitting him to purchase an additional \$10,000 of stock for each year it is outstanding.

*Example (2).* Assume the same facts as in example (1), and assume further that the option granted to E in 1964 is terminated in 1965 without any part of such option having been exercised, and that subsequent to such termination and during 1965, E is granted another option under P's employee stock purchase plan. Under such option, E may be permitted to purchase \$25,000 of stock for 1965. On the other hand, if, in 1966, E exercised the option granted to him in 1964 and purchased 600 shares of P stock, 500 shares, the maximum amount of stock which could have been purchased in 1965 under the option, is treated as having been purchased for the years 1964 and 1965. Thus, only 100 shares of the stock are treated as having been purchased for 1966, and E may be permitted under the new option to purchase for 1966 stock having a fair market value of \$15,000 at the time the new option is granted.



(j) *Restriction on transferability.* An employee stock purchase plan must, by its terms, provide that options granted under such plan are not transferable by the optionee otherwise than by will or the laws of descent and distribution, and must be exercisable, during his lifetime, only by him. For general rules relating to the restriction on transferability required by section 423(b)(9), see paragraph (b)(2) of § 1.421-7. For a limited exception to the requirement of section 423(b)(9), see section 425(h)(3).

(k) *Special rule where option price is between 85 percent and 100 percent of value of stock.* (1)(i) If all the conditions necessary for the application of section 421(a) exist, section 423(c) provides additional rules which are applicable in cases where, at the time the option is granted, the option price per share is less than 100 percent (but not less than 85 percent) of the fair market value of such share. In such case, upon the disposition of such share by the individual after the expiration of the 2-year and the 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) holding periods, or upon his death while owning such share (whether occurring before or after the expiration of such periods), there shall be included in the individual's gross income as compensation (and not as gain upon the sale or exchange of a capital asset) the lesser of—

(a) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time the option was granted, or

(b) The amount, if any, by which the price paid under the option was exceeded by the fair market value of the share at the time of such disposition or death.

For purposes of applying the rules of section 423(c) and this paragraph, if the option price is not fixed or determinable at the time the option is granted, the option price will be computed as if the option had been exercised at such time. The amount of compensation resulting from the application of section 423(c) and this paragraph shall be included in the individual's gross income for the taxable year in which the disposition occurs, or for

the taxable year closing with his death, whichever event results in the application of section 423(c).

(ii) The application of the special rules provided in section 423(c) shall not affect the rules provided in section 421(a) with respect to the individual exercising the option, the employer corporation, or its parent or subsidiary corporation. Thus, notwithstanding the inclusion of an amount as compensation in the gross income of an individual, as provided in section 423(c), no income results to the individual at the time the stock is transferred to him, and no deduction under section 162 is allowable at any time to the employer corporation or its parent or subsidiary with respect to such amount.

(iii) If, during his lifetime, the individual exercises an option granted under an employee stock purchase plan, but such individual dies before the stock is transferred to him pursuant to his exercise of the option, the transfer of such stock to the individual's executor, administrator, heir, or legatee is deemed, for the purpose of sections 421 and 423, to be a transfer of the stock to the individual exercising the option and a further transfer by reason of death from such individual to his executor, administrator, heir, or legatee.

(2) If the special rules provided in section 423(c) are applicable to the disposition of a share of stock by an individual, the basis of such share in the individual's hands at the time of such disposition, determined under section 1011, shall be increased by an amount equal to the amount includible as compensation in his gross income under section 423(c). However, the basis of a share of stock acquired after the death of an employee by the exercise of an option granted to such employee under an employee stock purchase plan shall be determined in accordance with the rules of section 421(c) and paragraph (c) of § 1.421-8. If the special rules provided in section 423(c) are applicable to a share of stock upon the death of an individual, the basis of such share in the hands of the estate or the person receiving the stock by bequest or inheritance shall be determined under section

1014, and shall not be increased by reason of the inclusion upon the decedent's death of any amount in his gross income under section 423(c). See example (9) of this paragraph with respect to the determination of basis of the share in the hands of a surviving joint owner.

(3) The application of this paragraph may be illustrated by the following examples:

*Example (1).* On June 1, 1964, the X Corporation grants to E, an employee, an option under X's employee stock purchase plan to purchase a share of X Corporation's stock for \$85. The fair market value of the X Corporation stock on such date is \$100 per share. On June 1, 1965, E exercises the option and on that date the X Corporation transfers the share of stock to E. On January 1, 1967, E sells the share for \$150, its fair market value on that date. E makes his income tax return on the basis of the calendar year. The income tax consequences to E and X Corporation are as follows: (i) compensation in the amount of \$15 is includible in E's gross income for 1967, the year of the disposition of the share. The \$15 represents the difference between the option price (\$85) and the fair market value of the share on the date the option was granted (\$100), since such value is less than the fair market value of the share on the date of disposition (\$150). For the purpose of computing E's gain or loss on the sale of the share, E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100. Since the share was sold for \$150, E realizes a gain of \$50, which is treated as long-term capital gain; (ii) the X Corporation is entitled to no deduction under section 162 at any time with respect to the share transferred to E.

*Example (2).* Assume the same facts as in example (1), except assume that E sells the share of X Corporation stock on January 1, 1968, for \$75, its fair market value on that date. Since \$75 is less than the option price (\$85), no amount in respect of the sale is includable as compensation in E's gross income for 1968. E's basis for determining gain or loss on the sale is \$85. Since E sold the share for \$75, E realized a loss of \$10 on the sale, which loss is treated as a long-term capital loss.

*Example (3).* Assume the same facts as in example (1), except assume that the option provides that the option price shall be 90 percent of the fair market value of the stock on the day the option is exercised. On June 1, 1965, when the option is exercised, the fair market value of the stock is \$120 per share so that E pays \$108 for the share of the stock. Compensation in the amount of \$10 is includible in E's gross income for 1967, the year of the disposition of the share. This is deter-

mined in the following manner: The excess of the fair market value of the stock at the time of the disposition (\$150) over the price paid for the share (\$108) is \$42; and the excess of the fair market value of the stock at the time the option was granted (\$100) over the option price, computed as if the option had been exercised at such time (\$90), is \$10. Accordingly, \$10, the lesser, is includible in gross income. In this situation, E's cost basis of \$108 is increased by \$10, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$118. Since the share was sold for \$150, E realizes a gain of \$32, which is treated as long-term capital gain.

*Example (4).* Assume the same facts as in example (1), except assume that instead of selling the share on January 1, 1967, E makes a gift of the share on that day. In such case \$15 is includible as compensation in E's gross income for 1967. E's cost basis of \$85 is increased by \$15, the amount includible in E's gross income as compensation. Thus, E's basis for the share is \$100, which becomes the donee's basis, as of the time of the gift, for determining gain or loss.

*Example (5).* Assume the same facts as in example (2) except assume that instead of selling the share on January 1, 1968, E makes a gift of the share on that date. Since the fair market value of the share on that day (\$75) is less than the option price (\$85), no amount in respect of the disposition by way of gift is includible as compensation in E's gross income for 1968. E's basis for the share is \$85, which becomes the donee's basis, as of the time of the gift, for the purpose of determining gain. The donee's basis for the purpose of determining loss, determined under section 1015(a), is \$75 (fair market value of the share at the date of gift).

*Example (6).* Assume the same facts as in example (1), except assume that after acquiring the share of stock on June 1, 1965, E dies on August 1, 1966, at which time the share has a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death, such \$15 being the difference between the option price (\$85) and the fair market value of the share when the option was granted (\$100), since such value is less than the fair market value at date of death (\$150). The basis of the share in the hands of E's estate is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (7).* Assume the same facts as in example (6), except assume that E dies on August 1, 1965, at which time the share has a fair market value of \$150. Although E's death occurred within six months after the transfer of the share to him, the income tax consequences are the same as in example (6).

*Example (8).* Assume the same facts as in example (1), except assume that the share of

stock was issued in the names of E and his wife jointly with right of survivorship, and that E and his wife sold the share on June 15, 1966, for \$150, its fair market value on that date. Compensation in the amount of \$15 is includible in E's gross income for 1966, the year of the disposition of the share. The basis of the share in the hands of E and his wife for the purpose of determining gain or loss on the sale is \$100, that is, the cost of \$85 increased by the amount of \$15 includible as compensation in E's gross income. The gain of \$50 on the sale is treated as long-term capital gain, and is divided equally between E and his wife.

*Example (9).* Assume the same facts as in example (1), except assume that the share of stock was issued in the names of E and his wife jointly with right of survivorship, and that E predeceased his wife on August 1, 1966, at which time the share had a fair market value of \$150. Compensation in the amount of \$15 is includible in E's gross income for the taxable year closing with his death. See example (6). The basis of the share in the hands of E's wife as survivor is determined under section 1014 without regard to the \$15 includible in the decedent's gross income.

*Example (10).* Assume the same facts as in example (9), except assume that E's wife predeceased him on July 1, 1966. Section 423(c) does not apply in respect of her death. Upon the subsequent death of E on August 1, 1966, the income tax consequences in respect of E's taxable year closing with the date of his death, and in respect of the basis of the share in the hands of his estate, are the same as in example (6). If E had sold the share on July 15, 1966 (after the death of his wife), for \$150, its fair market value at that time, the income tax consequences would be the same as in example (1).

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**§ 1.425-1 Definitions and special rules applicable to statutory options.**

(a) *Corporate reorganizations, liquidations, etc.* (1)(i) The term "issuing or assuming a stock option in a transaction to which section 425(a) applies" means, for purposes of sections 421 through 425, a substitution of a new option for an old option, or an assumption of such old option, by an employer corporation, or a related corporation of such corporation, by reason of a corporate transaction (as defined by subdivision (ii) of this subparagraph), if—

(a) The excess of the aggregate fair market value of the shares subject to the option immediately after the sub-

stitution or assumption over the aggregate option price of such shares is not more than the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

(b) The new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.

(ii) For purposes of this section, the term "corporate transaction" means any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any purchase or acquisition of property or stock by any corporation, any separation of a corporation (including a spin-off or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation, if such action by such corporation results in a significant number of employees being transferred to a new employer or discharged, or in the creation or severance of a parent-subsidary relationship.

(2)(i) A change in the terms of an option attributable to the issuance or assumption of an option by reason of a corporate transaction (as defined under section 425(a) and subparagraph (1)(ii) of this paragraph) is not a modification of such option. See section 425(h)(3) and paragraph (e) of this section. Thus, section 425(a), in effect, provides rules under which a new employer, or a parent or subsidiary of a new employer, may by reason of a corporate transaction assume a statutory option granted by the former employer or parent or subsidiary thereof, or issue a new statutory option in place of the option granted by the former employer or parent or subsidiary thereof, without having such assumption or substitution being considered as a modification of the option. For example, section 425(a) may apply where there is a merger of X Corporation into Y Corporation and Y Corporation wishes to employ the employees of X Corporation and to assume statutory options which